

Message Text

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SUBJ: DEVALUATION RUMORS RE-EMERGE

REF: LIMA 4658

1. WITH THE RECENT COUP IN PERU AND THE ASCENSION OF MORALES BERMUDEZ TO THE PRESIDENCY, DEVALUATION RUMORS HAVE AGAIN SURFACED. THE RE-EMERGENCE OF THESE RUMORS WAS NOT UNEXPECTED AS MANY PERUVIANS BELIEVE THAT MORALES BERMUDEZ WOULD NOT HESITATE TO TAKE SUCH A MEASURE IF NECESSARY IN SPITE OF HIS TOTAL REJECTION OF DEVALUATION DURING A TELEVISION APPEARANCE WITH THE "ECONOMIC" MINISTERS IN JUNE (LIMA 5303). RUMORS WERE FANNED BY THE NEW MINISTER OF ECONOMY AND FINANCE ON SEPTEMBER 3 WHEN HE REMARKED TO THE PRESS THAT "THE SITUATION MAY REQUIRE FISCAL AND FOREIGN EXCHANGE MEASURES WHICH MIGHT CREATE TEMPORARY ECONOMIC DISLOCATIONS."

2. KNOWLEDGEABLE MEMBERS OF THE FOREIGN BANKING COMMUNITY DIFFER GREATLY IN THEIR ANALYSIS OF THE POSSIBILITY OF A DEVALUATION. ONE AMERICAN BANKER BELIEVES THERE WILL

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BE A DEVALUATION WITHIN TWO WEEKS WITH THE NEW EXCHANGE

RATE AT 60-65 SOLES PER U.S. DOLLAR. HE CONTENTS THAT MORALES BERMUDEZ HAS BELIEVED FOR SOME TIME THAT A DEVALUATION IS NECESSARY AND BELIEVES THAT POLITICALLY THE TIME IS OPPORTUNE BECAUSE THE BLAME CAN BE PUT ON THE "OLD REGIME". ON THE OTHER HAND, A FOREIGN BANKER SAID THAT HE COULD SEE NO ECONOMIC JUSTIFICATION FOR A DEVALUATION. HE CONTENTS THAT DEVALUATION IS SUCH A SENSITIVE ISSUE TO THE AVERAGE PERUVIAN THAT THE GOP WOULD DEVALUE ONLY WHEN THE ECONOMIC PROBLEMS WERE SO SERIOUS THAT THERE WOULD BE ABSOLUTELY NO ALTERNATIVE. HE ADDED THAT A NUMBER OF THE GOP BANKING TECHNICIANS, AS WELL AS THE MINISTRY OF ECONOMY AND FINANCE, WERE OPPOSED TO DEVALUATION. HE NOTED THAT ONE PERUVIAN BANKING EXECUTIVE WOULD LIKE TO SEE THE DUAL RATES (43.38/38.70) COMBINED AT THE LOWER RATE, WHICH WOULD CONSTITUTE AN APPRECIATION OF THE SOL.

3. FACTORS FAVORING DEVALUATION INCLUDE THE FOLLOWING:

A. IN TERMS OF PURCHASING POWER PARITY, THE SOL IS OVERVALUED.

B. WITH A CHANGE IN THE PRESIDENT AND THE MINISTER OF ECONOMY AND FINANCE, THE BLAME FOR A DEVALUATION CAN BE PLACED SQUARELY ON THE OLD REGIME. FURTHERMORE, WITH A CIVILIAN MINISTER OF ECONOMY, THE ONUS ON THE MILITARY WOULD BE LESS SEVERE.

C. THE GOVERNMENT FACES WAGE DEMANDS IN THE CRITICAL MINING SECTOR, WHICH HAS BEEN ADVERSELY AFFECTED BY LOWER WORLD MINERAL PRICES. DEVALUATION WOULD INCREASE THE SOL INCOME OF THE MINES AND PERMIT THEM TO ABSORB HIGHER WAGES.

D. DEVALUATION WOULD NOT FUEL INFLATION IMMEDIATELY. THE FULL IMPACT OF DEVALUATION (INCREASED LOCAL COSTS AND IMPORT COSTS) WOULD NOT BE FULLY FELT FOR UP TO TWO YEARS. THIS WOULD GIVE THE GOP TWELVE TO EIGHTEEN MONTHS TO TAKE OTHER ECONOMIC MEASURES TO ASSURE RECOVERY.

E. FOREIGN EXCHANGE RESERVES HAVE FALLEN FROM APPROXIMATELY \$700 MILLION AT THE END OF 1974 TO UNDER \$300 MILLION RECENTLY. HOWEVER, SOME SOURCES (INCLUDING LOCAL IMF LIMITED OFFICIAL USE

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REPRESENTATIVE AND THE MINISTER OF ECONOMY AND FINANCE) CONTENT THAT THIS WAS MERELY A TECHNICAL DECLINE AND THAT THE RESERVE SITUATION IS ALREADY IMPROVING.

F. DEVALUATION WOULD RENDER PERU'S NONTRADITIONAL EXPORTS MORE COMPETITIVE.

4. THE FOLLOWING FACTORS MITIGATE AGAINST A DEVALUATION.

A. POLITICALLY, DEVALUATION IS ONE OF THE MOST SENSITIVE ISSUES IN PERU. BELAUNDE'S DEVALUATION OF THE SOL IN 1967 WAS ONE OF THE ELEMENTS CONTRIBUTING TO HIS OVERTHROW. PRESIDENT MORALES BERMUDEZ, IN HIS JUNE 30 ECONOMIC PRESENTATION TO THE NATION AS PRIME MINISTER, COMMITTED HIMSELF NOT TO DEVALUE. TO PERUVIANS, THIS WAS CONSIDERED TO BE ALMOST A MORAL COMMITMENT.

B. FORECASTS FOR THE RATE OF INFLATION IN 1975 RANGE FROM THIRTY TO FORTY PERCENT. DEVALUATION WOULD INCREASE THE INFLATION RATE EVEN MORE AND HIT ESPECIALLY HARD THE POOREST SECTORS OF THE SOCIETY. PREVIOUS ECONOMIC POLICIES, SUCH AS HEAVY SUBSIDIES ON ESSENTIAL CONSUMER GOODS, WERE IN PART BASED ON A FEAR THAT THE POTENTIALLY VOLATILE URBAN SLUM-DWELLERS MIGHT DEVELOP INTO A SOURCE OF SERIOUS OPPOSITION TO THE GOVERNMENT.

C. PERU'S EXPORTS ARE PRICE INELASTIC, AND IMPORTS ARE UNDER STRICT CONTROL. DEVALUATION WOULD CONTRIBUTE LITTLE TO FOREIGN EXCHANGE EARNINGS OR TO AN IMPROVEMENT IN THE BALANCE OF PAYMENTS. THERE ARE MANY OTHER MEASURES WHICH THE GOP COULD TAKE TO CONTROL IMPORTS INTO THIS LARGELY STATE-RUN ECONOMY.

D. THE INTERNATIONAL FINANCIAL INSTITUTIONS HAVE NOT BEEN PUTTING PRESSURE ON PERU TO DEVALUE. ALTHOUGH SOME FOREIGN COMMERCIAL BANKS BELIEVE PERU SHOULD DEVALUE, THEY APPARENTLY HAVE NOT BEEN PRESSURING THE &GOP EITHER.

5. AS TO PREDICTING WHETHER A DEVALUATION WILL OCCUR, WE DO NOT BELIEVE THE FACTORS FAVORING DEVALUATION ARE SUFFICIENT TO OVERCOME THE OBJECTIONS AND STILL DO NOT EXPECT A LIMITED OFFICIAL USE

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DEVALUATION IN THE IMMEDIATE FUTURE. HOWEVER, A DEVALUATION WOULD BE MOST PALATABLE POLITICALLY DURING THE NEXT FEW WEEKS WHEN MORALES BERMUDEZ COULD PUT THE BLAME ON THE ECONOMIC POLICIES OF HIS PREDECESSOR. THEREFORE, IF A DEVALUATION WERE TO COME IN THE VERY SHORT-TERM, THE MOST LIKELY TIME WOULD BE WITHIN THE NEXT THIRTY DAYS.
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